

The beat of the offshore wind

New concerns lead to tighter decision-making in asset servicing, say Chris Adams and Maria Cantillon

Historically when asset managers selected a new securities services provider, the location from which the operational services were to be delivered was seen as either a pretty mundane aspect of the overall selection criteria, or taken as a given based on the nature of the funds. The criteria used might include:

- The regulatory requirements for the fund to be serviced in a given location, or from one of a number of “recognized jurisdictions”
- Time zone support required by the manager and their distributors
- The requirement of the fund’s distributors to be serviced from a location where the staff had multi-lingual capabilities
- The preferences of the fund or its manager to be serviced from a given location, either for reasons of familiarity or as existing fund ranges are serviced or domiciled there

For example, the growth in assets serviced in Dublin was driven by the beneficial tax regime enjoyed by organizations based in the International Financial Services Centre (IFSC). The London hedge fund industry in particular realized that the well educated workforce in Ireland could service them well, in a country that is somewhat closer to home than the US or the Caribbean.

Similarly, Luxembourg’s growth was driven by the development of the UCITS product and the multi-lingual capabilities of its workforce. If you needed servicing in the American time zone, you selected an administrator in the Caribbean or the US—particularly after regulations were relaxed to allow investor records to be maintained onshore.

However, life is no longer as simple for those funds and managers looking at domiciles in which to launch new funds, and for service providers to support those funds. There are a number of factors driving this increasing complexity, some of which have emerged gradually over recent years, and others which have been brought into sharp contrast by the recent market turbulence.

COMPETITION BETWEEN JURISDICTIONS

The historic dominance of the major funds jurisdictions is under pressure as never before. Dublin, the Channel Islands, Luxembourg and certain Caribbean domiciles have all launched new vehicles or have amended existing legislation. These are measures aimed at making it easier for funds to be launched, to increase the tax transparency of vehicles, or to lighten the regulatory burden on the fund. So called onshore locations are taking increasing steps to make locally domiciled funds attractive to do-

mestic investors, with recent examples being changes to fund regulation and legislation in Italy and Spain.

The consequence of this is that fund promoters now have a far greater range of domiciles and vehicles from which to choose from, particularly for alternatives. Coupled with this increased choice, the concerns of the investor are increasingly weighing upon the domicile selected. Various Caribbean locations have historically held leadership positions as domiciles of choice for hedge funds. But some institutional investors and pension funds in particular, prefer to invest in funds domiciled in more rigorously regulated locations. This represents another driver behind the growth in Luxembourg, Dublin and the Channel Islands as domiciles of choice.

THE INCREASING GLOBALIZATION OF ASSET MANAGERS

Global asset managers want to be supported by as few asset-servicing providers as possible. Whilst in the past managers may have preferred to maintain relationships with a number of providers, the sheer cost of maintaining commercial relationships and technical links with multiple service suppliers has severely curtailed this trend. As managers have established management and distribution centers across the US, Europe and Asia, they expect their providers to

be capable of servicing them locally, even though the funds continue to be domiciled in the Cayman Islands or Dublin for example.

In addition, managers are expecting a full range of services to be delivered in the regions in which they are active. It is no longer acceptable simply to provide a fund administration offering in a given market—distribution support as well as the ability to trade directly in individual markets is increasingly important. Asking Asian distributors to wait for European or US service centers to resolve a particular issue is no longer acceptable. Many industry commentators talk about a follow-the-sun model, but few service providers have an offering which supports all asset classes across the three major regions. This is not a holy grail—it is the reality of what major asset managers are demanding and which service providers who want to be recognized as leaders will have to support.

DIVERSIFICATION INTO A BROADER RANGE OF ASSET CLASSES

Whether you want to refer to asset managers diversifying into a broader range of “traditional” and “alternative” classes, or the convergence between these asset classes, the message is clear: large asset managers expect their service provider to support a full range of asset classes. Asset managers increasingly cannot comprehend how a major service provider can claim to be a leading firm if it cannot support the full range of asset classes that it invests in, whether this investment occurs directly or through fund-of-fund structures.

SMALL IS NOT NECESSARILY BEAUTIFUL

There will always be a place for niche providers, but increasingly they will end up servicing locally domiciled niche managers. The increasing institutionalization of the alternative asset management industry in particular will drive this. For example, 75% of the top twenty fund-of-hedge-fund managers are now owned by large diversified financial groups. Large fund managers are attracting an ever increasing proportion of the assets invested into



these asset classes, and the requirements of the end investors, be they pension funds, insurance companies, sovereign wealth funds or private banks, require that major organizations are appointed to service their assets.

AN INCREASING FOCUS ON RISK

The author once worked on an outsourcing project for a global asset manager. The project was complex, expensive and involved a significant diversion of management attention. On one occa-



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sion the chief executive of the parent group visited the project team to understand the progress being made. One member of the team asked him why he allowed the organization to embark on such a challenging project. The chief executive replied that recently, when a major organization had gone bankrupt, he had had to make 12 different telephone calls to understand what his organization's exposure was to the bankruptcy. At that point he vowed that he would never be in that position again.

In the current period of market turbulence, this is probably a common concern amongst many chief executives. And for many, the next question that they will ask will be whether the service providers contracted to provide safekeeping, administration, risk management and credit services for their investments are likely to remain viable. Any uncertainty in this respect can be truly terrifying.

THE SERVICE PROVIDER CHALLENGE

These concerns create a number of potentially competing consequences for the service provider industry. The first point is that you have to be present where your major clients expect you to be. And not only do you have to be present, but you have to offer a complete suite of products. Certainly you can always offshore reconciliations to the cheapest location on the planet, but the relationship management teams need to be close to their client and their distributors, and need to understand the specificities of the investment products they support.

If you are to provide a complete suite of solutions in all major locations, the costs associated with its execution can be significant. Whilst fund administration, and to a degree transfer agency, are not necessarily capital intensive services to launch, custody and clearing certainly are. This includes both regulatory capital typically required and the intraday liquidity necessary to service contractual markets. If you layer on foreign exchange and liquidity services, the capital requirements rise further still. One cannot escape the conclusion, as evidenced by recent consolidation in the market, that increasingly the

leading securities servicing organizations are going to be major universal banks.

IN SUMMARY

A service provider capable of delivering a broad range of services across all regions, to all major fund domiciles and to all major asset classes is therefore going to have the following attributes:

- The service provider must be product-oriented. Only a focus on the specificities of the vehicles and assets to be serviced enables the service provider to offer a high quality service. This may seem a trivial comment, but there is absolutely no substitute for having an ingrained culture of deep technical expertise. It is the only way to anticipate risks before they occur, rather than having to resolve their impact after the event.
- The service provider must be financially robust, now more than ever. Investors expect both the managers and their service providers to stand in front of the services that they offer. It is therefore essential that the securities services provider is well capitalized and that the parent of the service provider is able to withstand financial shocks.
- The service provider must be dedicated to the industry in its own right. Recent consolidation in the industry has been broadly beneficial, not least by supporting the attribute highlighted above. However acquisitions and divestments can lead to disruption, not least within the service provider's organization itself. Perhaps the greatest challenge that any provider faces is maintaining its client-facing teams. Any disruption to these teams has an immediate and transparent impact on its clients, and is rarely positive.

- An existing global footprint is key. The sheer regulatory burdens of establishing new locations (particularly when a complete service offering is being proposed) mean that it is critical that all major locations are in place. Increasingly this will require onshore as well as offshore servicing capabilities and therefore the investments required to provide a truly global model will only increase.

Whilst this article has focused primarily on the challenge of servicing alternative assets, many of the points raised are equally important to the so called traditional sector. Clearly what is important across the entire spectrum of asset classes is that there is total alignment between the requirements of the fund vehicles, the assets managed, the servicing of the assets and the servicing of the end investors. At BNP Paribas Securities Services we continue to invest in our asset servicing capabilities, and are supported in this by being part of one of the three highest rated financial institutions in the world.



BNP PARIBAS
SECURITIES SERVICES

Contact:

Maria Cantillon
Global head of sales, alternative funds
Tel: +44 207 410 2696
Maria.cantillon@bnpparibas.com

Chris Adams
Global product head, alternative funds
Tel: +352 26 96 2801
Chris.adams@bnpparibas.com